Building Widespread Prosperity:
Income Tax Cuts Won't Get You There

Michael Leachman
Director of State Fiscal Research
leachman@cbpp.org
February 13, 2015

Keynote Remarks
Let's Get Fiscal: MECEP's Tax and Budget Conference

Hi everyone it's great to be here.

First I want to say how great it is to be at an event sponsored by the Maine Center for Economic Policy. Garrett and his team do really important work. I really respect their vision for Maine as a state with a strong economy in which everyone participates, one where thoughtful public policy is laying the groundwork for an even stronger future.

I also want you to know that MECEP not only makes a huge difference to policy making in Maine, it's part of a network of independent state fiscal policy groups all over the country sharing bold, innovative ideas and using thoughtful and very timely analysis to promote WIDESPREAD prosperity. Here's a map showing all the states with state fiscal policy groups like the Maine Center for Economic Policy. **CHART**

When asked why he robbed banks, Willie Sutton said "that's where the money is." The folks at MECEP and their colleagues around the country could say the same thing about why they focus on fiscal policy – that's where the money is. It matters for everything. So having people like Garrett and his team who are helping policy makers make sound fiscal policy decisions is really important because it matters a LOT for the quality of our lives and the strength of our communities.

So thanks to MECEP, and all of you, for the work that you're doing. It's very, very important, not only to Maine but the whole country.

The decisions being made right now in Maine and other states is so crucial because – unlike in many countries around the world -- it's states and localities that are responsible for delivering many of our basic national priorities. The education of our people, the safety of our communities, our court system, fire protection, the maintenance of roads and other physical infrastructure – all primarily funded and managed at the state and local level.

In the last few years, it's been very difficult for states to deliver these priorities because the recession has been so deeply damaging to state revenues.

It's been seven years since the recession began, and in many states, funding for schools, for example, is STILL well below pre-recession levels. Here in Maine, the basic form of state support for K-12 schools is down 13 percent per student, after you adjust for inflation. That's a huge cut, one of the worst in the country. Funding for public colleges and universities is down, too – in nearly every state in the country, including Maine. That's driven up tuition, which is very likely keeping some capable students away from our campuses at a time when we need highly educated people for the jobs of the future. Many of our roads and bridges are in bad shape. And we have millions of children, the country's future, living in families that some nights don't have enough money to get a decent meal on the table. Of course, many of these challenges were with us before the recession, but the recession made them much worse – and left states with fewer resources to deal with the challenges we face.

As the economy has begun to improve, some states have found ways to speed up the repair of their education systems and other important public services, or even make major improvements. Minnesota, for example, is now offering free, all-day kindergarten in public schools across the state, funding early education scholarships to low-income children, and making college more affordable for Minnesota's students -- thanks to a revenue raising measure whose core was a reasonably sized income tax increase for Minnesotans who are very well off.

Some states, though, are headed in an entirely different direction, or at least they are talking about heading in a different direction. These states – and Maine is one of them -- are betting their futures on some dubious ideas that promise fantastical results.

These states are pursuing the elimination or major diminishing of their state's income tax. This is the most significant and unique aspect of state fiscal policy making in this historical moment. It's really striking, and – for someone who believes states will drive the country's future – very concerning.

These proposals would take Maine -- and some other states -- down a path that will make it very difficult, if not impossible, for you to maintain and build a strong education system and more generally to invest in your people – and if that happens, Maine, these other states, and by extension the country – will be much worse off.

Now, to be clear, I'm optimistic about the country's future. Most states are taking a more prudent and responsible approach. Some of the states that have considered these proposals most vigorously have rejected them. Other states have not caught themselves up in these debates at all. And I'm optimistic that you will reject this path in Maine.

But given how prevalent these drastic income tax cutting proposals are, it's worth looking closely at how things are going in the states that already have enacted them.

The first place to look is Maine itself, since in 2011 you enacted income tax cuts that started you down this path. These were significant cuts, among the five deepest income tax cuts any state has enacted in recent years.

I know I don't have to tell you that the economic impact of the tax cuts has been far from what the proponents of tax cuts typically promise.

Private sector job growth in Maine since the tax cuts first took effect in January 2012 is LESS THAN HALF the rate of job growth nationally. Here's the specifics. **CHART**. Private sector job growth nationally is up seven percent. In Maine, it's up only 3 percent.

What about other states that are trying out this same experiment? Kansas has been the most aggressive of all the states in pushing to eliminate income taxes. They slashed income taxes two years ago, cutting their rates and eliminating all personal income taxes on certain forms of business income.

Since then, their economy has been sluggish and their state's finances have fallen into complete disarray. Their bond rating has been cut. They have almost entirely drained their rainy-day funds. They are drawing on their road-building funds to cover their operating costs over the next few months. Class sizes in their schools are up, and more cuts for schools are on the way. The state's courts have ruled that the state is unconstitutionally underfunding the schools, but the governor is fighting the ruling and promising to continue the state's march toward income tax elimination.

When he signed the tax cut bill, Kansas' governor Sam Brownback said it would be a shot of adrenaline into the heart of the Kansas economy. But private sector job growth in Kansas since the tax cuts took effect two years ago is much slower than it's been nationally.

And the state's official forecasters project that personal income in Kansas will grow MORE SLOWLY than it will nationally into the foreseeable future. There is no economic boom coming to Kansas. Just more financial difficulties, and more cuts to schools and other state services that are crucial to the state's economic future.

And all this is in THE state that has taken the biggest strides toward eliminating its income tax – the same path your governor wants Maine to take.

What about other states that have cut their income taxes in recent years? Well, besides Kansas and Maine, the biggest cuts have happened in Wisconsin, Ohio, and North Carolina.

Wisconsin and Ohio first started cutting their income taxes two years ago. In both states, private sector job growth since then has lagged well behind job growth nationally. Ohio's added jobs at only about half the pace of the country as a whole. Wisconsin's done a little better, but still trails the rest of the country by a significant margin.

North Carolina, which enacted its tax cuts only a year ago, is the exception among the five biggest income tax-cutting states. That's the one state of the five where private sector job growth has exceeded the country's since the tax cuts were enacted. Their job growth has been far from spectacular, but it has been stronger than in the U.S. as a whole.

The weak jobs performance of most of the income tax-cutting states so far comes as no surprise to those of us who have been following these sorts of policies for many years.

For instance, in the 1990s, the national economy was booming and many states cut taxes. My colleagues and I have looked at how the states that cut taxes the most during those years performed over the next economic cycle, compared to states that were more prudent. The states that cut taxes the most saw job growth that was just ONE- THIRD the rate of job growth in states that were more cautious.

And the academic literature on this topic overwhelmingly rejects the idea that personal income tax levels are important drivers of economic growth. The vast majority of empirical studies on this topic published in academic journals find that the level of state personal income taxes in a state is an insignificant factor in determining how quickly the state economy will grow.

The fact that big tax cutting states aren't seeing a boom also makes sense for other reasons. For one thing -- at the state level, tax cuts have to be paid for with tax increases elsewhere or public service cuts, and those steps counteract the effects of the tax cuts and may even leave you worse off.

A second reason is that state and local taxes are often higher in some locations than others because they are financing higher-quality public services: better schools, universities, roads and mass transit, better police protection, etc. When higher taxes pay for better services, they may have no adverse impacts on location decisions whatsoever and may even have positive impacts (when, for example, the reduction in other business costs exceeds the taxes themselves).

A third reason why income tax cuts have so little effect is that other factors are much more important to a state's economic growth. Trends in the national and international economy, a state's natural resources, the education of its workforce, the proximity to major markets, and the mix of industries in a state. These are among the major factors that determine the growth of state economies. Differences among states in state personal income taxes, by contrast, are a very minor issue.

Now, one thing you sometimes hear claimed in these debates is that if states like Maine eliminate their income taxes, then more people will want to move here. The basic story is that states like Texas and Florida – states with no income taxes – have seen their populations grow faster in recent decades than states like California and New York, and therefore states that eliminate their income tax will see THEIR population grow faster too.

These claims are highly misleading. The truth is that for decades, Americans have been moving away from the Northeast, the Midwest, and the Great Plains to most of the southern and southwestern states, *regardless of overall tax levels or the presence of an income tax in any of these states.* For example, a lot of people moved to Texas in the last 20 years or so, but if people were moving there because Texas has no income tax you wouldn't expect that almost as many people would move to Arizona during the same period. Arizona levies an income tax, and it's a much smaller state than Texas, with many fewer jobs for a potential transplant to fill. But that's exactly what happened. Arizona has nearly matched Texas in people moving in from other states over the last roughly 20 years.

I can tell a similar story about North Carolina, a state that has had a relatively high income tax. That state has also seen a lot of people moving there. In fact, over the last roughly 20 years, more than twice as many people moved to North Carolina than moved to neighboring Tennessee, even though Tennessee has no real income tax.

And by and large it's LOW- and MIDDLE-income people that are moving to states without income taxes, NOT wealthy people fleeing states with high income taxes. You can see this looking at California, which lost middle and lower income people because housing costs were so high along the Pacific coast. It wasn't rich people who were moving, by and large. Silicon Valley is still home to an awful lot of very wealthy people.

Here's an interesting fact: a higher share of the people who moved from Texas to California have high incomes than those going in the other direction – exactly the opposite of what you'd expect if income taxes were a major reason why people move.

To be sure, some people relocate because they think their taxes are too high or take state and local tax levels into account in deciding where to live. Nonetheless, there is overwhelming evidence that those cases are sufficiently rare that they should not drive state tax policy formulation.

One thing you SHOULD focus on is how to support and increase your state's supply of successful entrepreneurs. These people and their companies really do grow the economy by creating new products or otherwise bringing innovations to market. There are a number of steps you can take to support them and increase their numbers. Identifying your state's existing strengths and clusters of innovation, helping entrepreneurs to connect with each other and with financing opportunities, building a strong culture of innovation and entrepreneurialism in your research universities and even in your community colleges and high schools, and – most importantly – making smart public investments that result in a well-educated workforce, safe neighborhoods, and a generally high quality of life for people living your state.

Why is that so crucial? Well an important survey last year asked the founders of 150 of the fastest growing companies in the nation why they founded their companies where they did. The answer, by and large, was that they founded their companies where they already were living, and in areas with a high quality of life and the workforce they needed to produce their products. Only five percent of these highly successful entrepreneurs even mentioned taxes. In fact they mentioned taxes as a reason only about as often as they mentioned "girlfriends."

So don't worry so much about attracting entrepreneurs to move INTO your state from other states. Focus on the people you HAVE, invest in THEM to help them be successful, and build a state that's an exciting and dynamic place for those people to found and grow their companies.

Let me conclude by emphasizing once more what a crucial historical moment this is. States are at the crossroads of history, and you are at the forefront of the debate. The decisions you all in Maine make over the next couple years will help decide which way we go as a nation. Will states stick with measured and thoughtful approaches to state fiscal management and build the human capital and physical infrastructure that will revitalize the country in this new century?

Or will we go off running after mirages? Illusions that promise economic nirvana and a free lunch to boot – but end up undermining the very foundations of sustained economic strength and WIDESPREAD prosperity?

As I've said, I'm optimistic that Maine will lead us in the right direction. Good luck! I really admire the work that you're doing, and look forward to hearing your insights and questions.